



Economic Review & Outlook

SECOND QUARTER | 2023

Fasten Your Seat Belts: Will the Economy Have a Soft or Hard Landing or No Landing at All?

Recession fears have continued to grow since the U.S. Federal Reserve (Fed) started tightening monetary policy in early 2022. These scenarios often lead experts and even Fed officials to use an aeronautical analogy. They compare the potential path of the economy to a plane touching the runway after a flight, debating whether it will experience a hard or soft landing.

In 2023, that discussion has intensified. The Fed's stated goal is a soft landing, in which the economy slows enough to cool inflation but avoids a recession. It's not an easy assignment. The other end of the spectrum is a hard landing, which equates to a recession, and there are plenty of experts who believe that's where we're headed. This year a third option has surfaced: no landing. In this scenario, the economic slowdown in the first half of 2022 represents a quick touchdown for our economic plane, followed by a re-acceleration of growth with no real "landing" at all. That, too, remains a possibility, though it appears less likely after March's banking turmoil.

In this newsletter, we'll look closely at all three types of landings, discuss what it would take to accomplish each, and offer some insights into how investors can navigate the situation.

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Economic Overview

SUPERCORE INFLATION COMES TO THE FORE

So-called headline inflation, measured by the U.S. Consumer Price Index (CPI) has cooled since reaching a 41-year peak in June 2022. Core CPI, which excludes food and energy prices, has followed a similar path. This deceleration in CPI predominantly resulted from decreases in the prices of energy and consumer goods. However, the services and shelter categories of Core CPI have remained steady.

The Fed's preferred inflation gauge—the Personal Consumption Expenditures (PCE) price index—has also slowed. In recent months, however, the Fed has pointed to a lesser-known data point, “supercore inflation,” as a key measure of central bank monetary policy. Fed officials break core PCE inflation into three components: core goods, housing, and core services excluding housing. The last one, which is viewed as the centerpiece of core inflation, is the “supercore”. It's been running at about 4%—like all the other gauges, which are well above the Fed's 2% target—and policymakers have repeatedly noted that it remains a key concern. Why? Core goods inflation has returned to pre-COVID levels. Housing inflation remains hot, but the Fed expects it to start cooling this summer. Supercore inflation, which ran around 2% before the pandemic, remains high, tends to be more persistent than the other components, and has shown no real signs of slowing. (To learn more about supercore inflation, read our recent blog post, [Supercore Inflation: The New Focus of Federal Reserve.](#))

BANKING TURMOIL OF 2023 HAD A MAJOR IMPACT

Expectations for the Fed's path forward—which has been a key driver of equity and other markets for months—were extremely volatile leading up to the Fed's latest meeting on March 22. After a 0.25% hike in February, a 0.50% increase in March was becoming more likely due to the strong economic and inflation data. However, that all changed on March 8 when Silicon Valley Bank (SVB) announced a \$1.8 billion loss on the sale of bonds as they were forced to sell assets to cover a deluge of deposit withdrawal requests. The bank's stock plummeted on March 9, pulling shares of many of the nation's biggest banks down with it. The banking turmoil caused Fed expectations to shift dramatically, making it very difficult to forecast both the Fed's upcoming moves and the type of landing we should expect.

The fallout from the collapse of SVB, a bank with more than \$200 billion in assets that focused mainly on startups, played a critical role in the

Fed's path and broader market results in March. After SVB experienced a bank run of unprecedented demand and speed, federal regulators took over the bank on March 10, marking the second-biggest bank failure in U.S. history, after Washington Mutual's 2009 collapse at the height of the Great Financial Crisis (GFC). Signature Bank also failed, marking the third-largest bank failure in history, and First Republic Bank required a multibillion lifeline from larger banks such as JP Morgan, Citigroup, and Bank of America. European giant Credit Suisse Group also came under additional pressure and was eventually bought by UBS, while shares of other banks in Europe and U.S. regional banks all plummeted as depositors' fears rose.

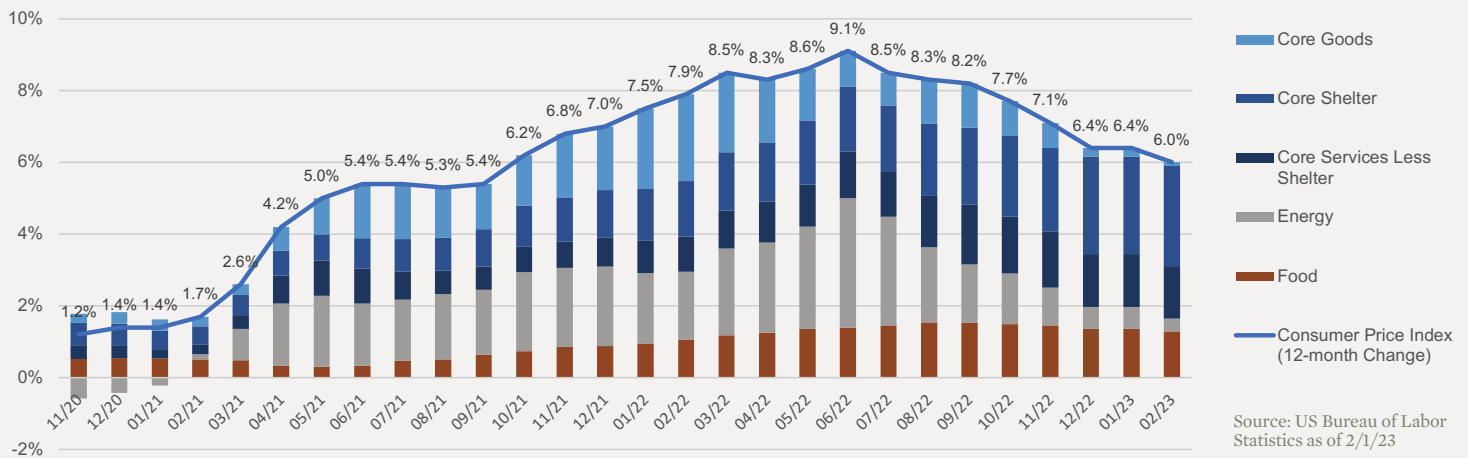
An important difference between the recent domestic bank failures and the ones during the GFC is that the previous failures resulted from investing in bad assets, whereas the current turmoil is liquidity driven. While we're not excusing the poor business decisions or inadequate risk management of SVB and Signature Bank, we think it's important to note that these banks failed not because of poor quality investments, but rather because they were forced to sell and realize losses to try to meet customers' withdrawal requests.

After the Fed stepped in to insure all deposits—even those above the Federal Deposit Insurance Corporation (FDIC) insurance coverage level of \$250,000—and offered a new emergency liquidity facility for banks (the Bank Term Funding Program), the situation was contained for the time being, but some customers with deposits above the FDIC coverage amount still have concerns. Regional banks across the country were also hit with withdrawal requests as customers sought to hold on to their physical cash or move their deposits to a larger institution. The Fed is very aware of the ramifications of a countrywide bank failure and is doing everything it can to assure customers that the banking system is healthy and customer deposits are secure. Fed Chair Jerome Powell stated, “We took powerful actions with Treasury and the FDIC, which demonstrate that all depositors' savings are safe.”¹ (To learn more about what Ronald Blue Trust offers to protect your assets, read our recent blog post, [“Is My Cash Safe?”](#))

It's uncertain what implications this banking turmoil will have for the future. There are discussions around temporarily increasing the FDIC coverage amount, but the situation is continually evolving. Other short-term impacts may include banks tightening their lending standards and shoring up their balance sheets. In the long term, these events could lead to increased bank regulation and/or consolidation of banks.

¹ www.reuters.com/markets/us/bank-deposits-have-stabilized-last-week-powell-says-2023-03-22/

CONTRIBUTION TO 12-MONTH CHANGE IN CONSUMER PRICE INDEX



Source: US Bureau of Labor Statistics as of 2/1/23

Asset Class Performance

Equities advanced in the first quarter, rallying amid optimism about the future path of interest rates, before retreating as investor sentiment shifted toward a belief that the Fed will keep rates higher for longer. Concerns about bank failures and tightening lending standards also weighed on equities in March. U.S. stocks performed in line with global and developed-market equities while emerging markets posted a more modest gain for the quarter. Growth stocks—bolstered by the information technology, communication services, and consumer discretionary sectors—led markets higher, while energy and financials had the quarter’s sharpest declines. The Fed’s aggressive rate tightening was a headwind for bond markets, but worries about contagion in the banking system provided a tailwind as the market now expects the Fed to pause and possibly lower rates (as of 4/4/23).

The banking crisis helped drive a slump in oil prices amid worries that a global recession could crimp demand. Commodities broadly declined during the quarter and gold prices moved inversely with oil, declining slightly before the banking crisis and rallying sharply thereafter, to post a quarterly advance.

January	February	March	YTD
Int'l Developed Stocks 8.1%	Int'l Developed Stocks -2.1%	Gold 7.6%	Int'l Developed Stocks 8.6%
Emerging Market Stocks 7.9%	U.S. Stocks -2.4%	U.S. Stocks 3.7%	Gold 8.1%
U.S. Stocks 6.3%	Diversified Bonds -2.6%	Emerging Market Stocks 3.1%	U.S. Stocks 7.5%
Gold 6.0%	Commodities -4.7%	Int'l Developed Stocks 2.6%	Emerging Market Stocks 4.0%
Diversified Bonds 3.1%	Gold -5.2%	Diversified Bonds 2.5%	Diversified Bonds 3.0%
Commodities -0.5%	Emerging Market Stocks -6.5%	Commodities -0.2%	Commodities -5.4%

Indices used: Commodities—Bloomberg Commodity Index, Diversified Bonds—Bloombergs Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges, and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

Our Perspective

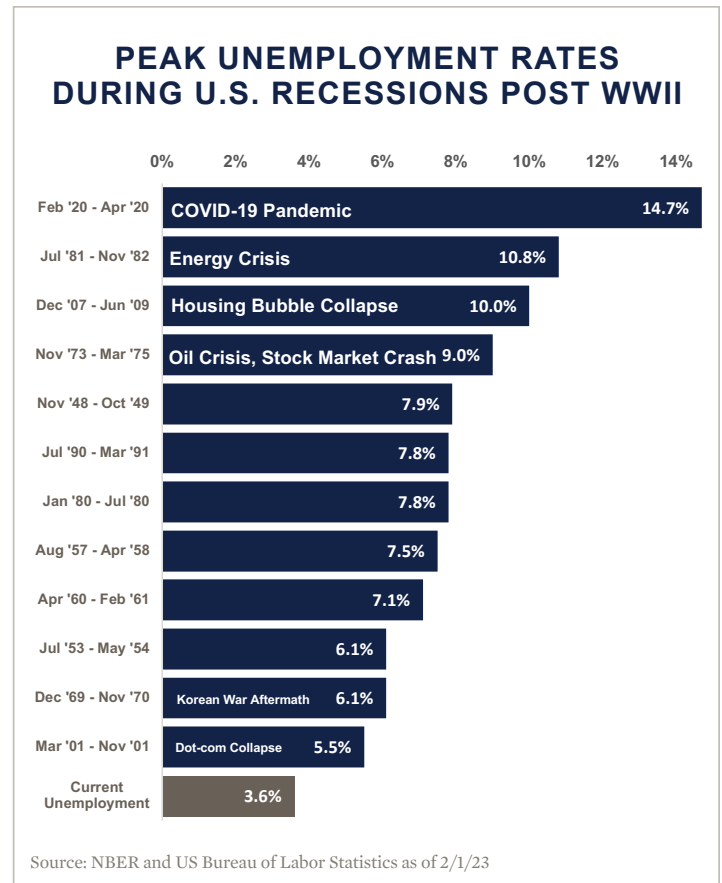
As we’ve seen during the past decade-plus of accommodative monetary policy, the Fed has the power to support economic activity through tools such as lowering interest rates and quantitative easing. Years of near-zero rates and trillions of dollars’ worth of bond purchases by the Fed helped propel the longest economic expansion in U.S. history, until it was halted by the pandemic in early 2020. The central bank can also help slow the economy by restricting or tightening policy, as it started

to do in March 2022, with the goal of cooling inflation. It’s a delicate balance, and when rates rise, recessions often follow.

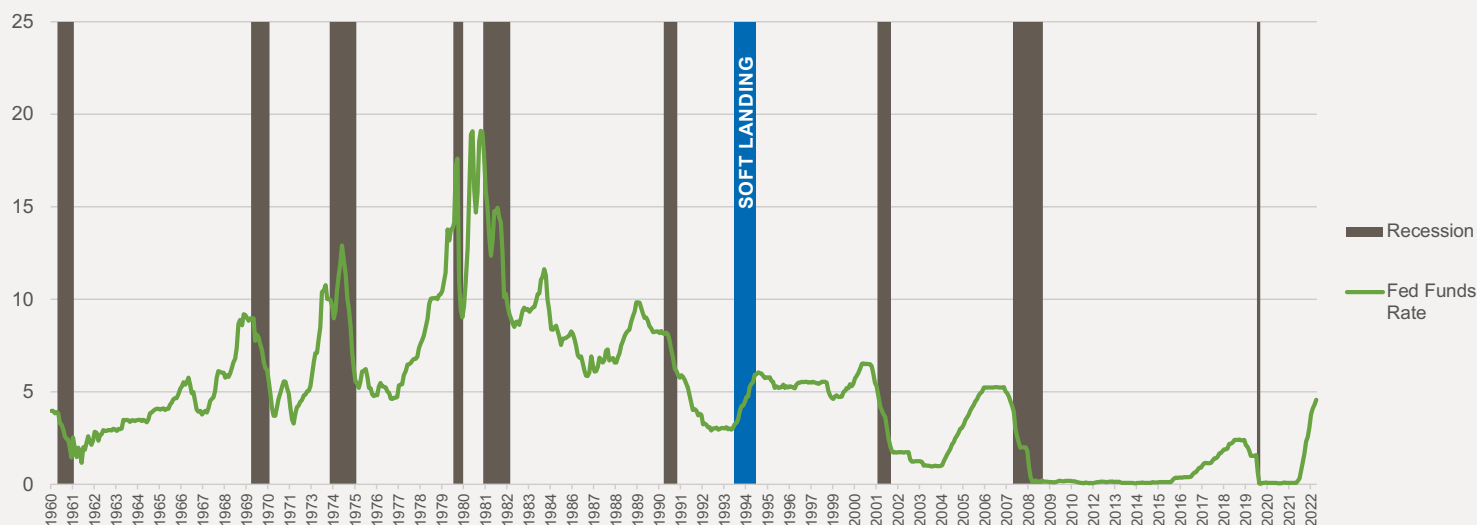
The Fed, of course, isn’t solely responsible for recessions, but it does play a key role in them. So far, the Fed appears to have done a good job of slowing inflation without pushing the U.S. into a recession, according to the National Bureau of Economic Research (NBER). If the Fed tightens too much, a recession will almost undoubtedly follow. If the Fed doesn’t tighten enough, inflation could spike once again, or at least remain elevated, which could also lead to a severe pullback in the economy.

The NBER’s traditional definition of a recession is “a significant decline in economic activity that is spread across the economy and lasts more than a few months.” Recessions vary, of course, in their length, severity, and depth. The NBER says the average length since 1854 is 17 months, with a high of 43 months from 1929–1933, the first of two major recessions during the Great Depression. Since World War II, the average recession has lasted just over 11 months. The longest was from December 2007 to June 2009, while the shortest was in 2020 when the pandemic-induced downturn only lasted two months. One way to measure the depth and severity of a recession is through unemployment figures because unemployment tends to rise, often sharply, during those periods.

U.S. equities tend to decline during recessions. Since the 1920s, the S&P 500 has hit a low during 13 of the 15 NBER-defined recessionary periods. Those periods have averaged 13 months, and the market bottom occurred an average of eight months into the recession. The index has lost an average of 6.4% during recessions. However, if one eliminates the Great Depression and the GFC—the longest recessions of the last 100 years—the picture is much brighter, with the S&P 500 posting a 1.8% advance during the period, on average.



FED FUNDS RATE DURING RECESSIONS



Source: NBER and US Bureau of Labor Statistics as of 2/1/23

A HARD LANDING VERSUS A SOFT LANDING

As we noted earlier, the hard-landing scenario generally refers to a recession that lasts for a long time with widespread layoffs and high unemployment, which would lead to a pullback in spending, as well as increased delinquencies and defaults. In the worst-case scenario, inflation continues to run hot and combines with slowing growth to produce stagflation, which last gripped the economy in the 1970s. One of the strongest examples of a hard landing happened soon after, in 1981–1982. The Fed raised interest rates by more than 10% in six months through January of 1981 (to above 19%) amidst double-digit inflation, which was soon followed by double-digit unemployment during a recession that the NBER defined as 16 months long.

Generally speaking, a soft landing describes a period in which the central bank manages to slow the economy at the “right” pace to reduce demand and rein in inflation, keeping the recession short and shallow. In this scenario, economic growth doesn’t contract much, if at all, and unemployment does not spike.

The best example of a soft landing occurred between 1994 and 1995. At the time, Fed Chair Alan Greenspan and his colleagues grew concerned about inflation, though it was relatively low (2.8% in February of 1994), and unemployment was running stable at under 7%. The Fed raised rates seven times that year, from 3% to nearly 6%. Inflation hovered around 3% for several years before dipping toward the Fed’s 2% target, and unemployment fell to a low of 3.8% by early 2000. Gross Domestic Product (GDP) growth dipped in 1995 but largely remained strong through the rest of the 1990s.

NEW FOR 2023: THE NO-LANDING SCENARIO

Given a strong labor market, encouraging consumer-spending data, and the fact that the economy has yet to enter a recession (by the NBER’s criteria), the notion of “no landing” gained some traction earlier this year. In such a scenario, the economy would continue to grow and avoid a recession, despite interest rate increases that manage to slow inflation.

WHICH IS MOST LIKELY TO OCCUR?

Before we try to look ahead, let’s review where things stood at the end of the first quarter of 2023. The Fed raised the benchmark federal funds rate by 0.25% in March, marking the ninth consecutive increase totaling 475 bps, to a target of 4.75%–5%. As for inflation, the data shows that it may have peaked in June 2022. February’s CPI rose a bit as expected, due largely to shelter costs, and came in at 6% year-over-year, well below June’s 9.1% high. The core inflation figure was up 0.5% in February and 5.5% from a year earlier. The banking turmoil likely helped limit the rate hike to a quarter-point. The economy appeared resilient to a year’s worth of hikes, with 2.9% fourth-quarter GDP growth and the Atlanta Fed’s GDPNow model forecasting similar numbers for the first quarter of 2023 (as of 3/31/23). In other words, it looks like the Fed has more work to do because getting inflation down closer to its 2% target will likely prove much more difficult than it was to get inflation from 9% to below 6%.

We believe a no-landing scenario is the least likely to play out. While strong retail sales and historically low unemployment brought that idea to the foreground in early 2023, the probability of no landing has faded. The resilience of the job market and supercore inflation will likely keep the Fed from cutting anytime soon.

A soft landing remains a possibility. The housing market would likely have to cool off as we move into summer, allowing core-services inflation to follow suit. We believe the labor market could tolerate a moderate increase in unemployment without weighing too heavily on economic growth, allowing the Fed to avoid overtightening. If that all happens, we could see lower GDP growth over the short term, followed by a relatively quick rebound.

We can hope for a soft landing, but it’s wise to prepare for the possibility of a hard landing. The Fed has indicated they are willing to do what it takes to bring inflation back to target levels, even if it means a recession. Remember, interest rate hikes tend to take six to 12 months to work their way through to the market, so we may see continuing volatility over the short to medium term.

Another challenge of trying to predict what type of landing we could experience is the fight over the debt ceiling in the U.S. Congress. In January, the government reached its \$31.4 trillion borrowing limit, raising the unsettling possibility of a default that could spell disaster for the global economy. Reaching the debt ceiling occurs fairly regularly: Since 1960, Congress has permanently raised, temporarily extended, or revised the limit nearly 80 times—often with a fairly routine vote. That’s changed in recent years though as the division between (and within) political parties has deepened and the debate has grown more rancorous. Congress will likely reach a solution, but it could take a while, and the closer we get to the June–September “X date” (when the government would no longer be able to meet its obligations in a timely fashion) the more concerns could grow, likely fueling more market volatility. (For more information, including thoughts on the possibility that Congress will not reach a compromise in time, check out our recent blog post, [“The U.S. Has Reached its Debt Limit: Now What?”](#))

Our Investment Strategy

We’ve made changes over the last 12 months to better prepare our portfolios for the increasing probability of a recession. Even though bonds didn’t provide their historical diversification benefit to stock drawdowns in 2022, we still believe that beneficial relationship will continue in the future. In fact, bonds have already significantly recovered as evidenced by the Bloomberg Aggregate U.S. Bond Index rising 2.5% during March when stocks sold off or were flat during the banking turmoil. Bonds have traditionally performed well during

recessions, and with yields higher than they have been in a long time, we have increased our allocation to U.S. Treasuries.

Our long-term solutions are diversified to help cushion losses in a recession, but we still believe investors should hold stocks in their long-term portfolios. Since valuations were reset across the board last year, international stocks appear particularly attractive and also provide diversification from a potential domestic recession.

Conclusion

It is human nature to speculate, and there is no shortage of market pundits who profess to know what’s coming next. The fact is, no one knows what kind of landing we’re in for, or how the economy and markets will shake out across the rest of 2023 or beyond. There are simply too many variables—the job market, the banking crisis, the Fed’s actions, and on and on—to allow for accurate predictions. Amid today’s very high degree of uncertainty, we rely on our investment principles and the three pillars of our investment approach to keep us grounded. We strive to invest in markets and geographies that are growing at an above-average pace. We carefully weigh price compared with value and seek not to overpay for an asset based on its growth potential, and we construct appropriately diversified portfolios relative to our clients’ time horizons and future cash flow needs. Finally, we believe that history can help inform prudent decisions but acknowledge that God is ultimately in control. Given that reality, we believe that especially in times like these, the best way to achieve long-term investment success is to choose an appropriate strategy and follow a disciplined process.

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